

No. 9270

IN THE
**United States Circuit Court
of Appeals**
For the Ninth Circuit

J. H. McCUNE, ALICE W. JACKSON, ALICE P. JACKSON,
and FRED D. JACKSON,

Appellants,

vs.

FIRST NATIONAL TRUST AND SAVINGS BANK OF SANTA
BARBARA, HORACE P. HOEFER, PETER DAVIDSON,
CATHERINE DAVIDSON, and GEORGE GIOVANOLA,
Trustee in Bankruptcy, of the Estate of Mortgage
Securities, Inc., of Santa Barbara, a Corporation,
Bankrupt,

Appellees,

and

J. H. McCUNE, ALICE W. JACKSON, ALICE P. JACKSON,
and FRED D. JACKSON,

Appellants,

vs.

THOMAS J. SMITHERAM, E. W. SQUIER, and J. F. GOUX,

Appellees,

APPELLANTS' PETITION FOR REHEARING

Presented by Appellants After Decision
Affirming Orders of District Court

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SUBJECT INDEX

Page

“A”

Grounds For Re-Hearing	2
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“B”

Does Section 322a of the Civil Code of the State of California impair the obligation of contracts in violation of Article 1, Section 10, Clause 1, of the United States Constitution?	3
General Rules of Law Applicable to the Constitu- tional Question.	4
The Contract and its Obligation.	10
Impairment of the Contract Obligations.	17
Specific Errors in the Statements of the Court in its Decision.	23

“C”

Does Section 322a of the Civil Code of the State of California violate the Provisions of Article 1, Paragraphs 13 and 16, of the Constitution of the State of California?	30
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“D”

Can Section 322a of the Civil Code of the State of California be construed in such a manner as not to make it violative of the Constitutions?	30
Conclusion	32
Certificate	33

TABLE OF CASES AND AUTHORITIES CITED

Page

Abilene National Bank vs. Dolley, 228 U. S. 1	5
Adams Pipe Works vs. Okell Well Machinery Co., 136 Cal. App. 608.	12
Aronson and Co. vs. Pearson, 199 Cal. 286.	12, 15, 17, 31
Barnitz vs. Beverly, 163 U. S. 122.	9
Bradley vs. Lightcap, 195 U. S. 1.	8
Bronson vs. Kinzie, 1 How. 311, 315.	5
Butz vs. Muscatine, 8 Wall. 583.	9
Chicago vs. Sheldon, 9 Wall. 50.	6, 15
Chicago, B. and Q. R. Company vs. Cram, 228 U. S. 70.	5
Civil Code of the State of California, Section 309.	12
Civil Code of the State of California, Section 322a.3, 11, 13, 17, 20, 21, 22, 23, 24, 25, 26, 27, 28, 29, 30, 31	31
Civil Code of the State of California, Section 346.	13
Civil Code of the State of California, Section 363.	13
Civil Code of the State of California, Section 364.	13
Cleveland vs. Pennsylvania, 15 Wall. 300, 320.	8
Columbia R. Gas and E. Company vs. South Carolina, 261 U. S. 236.	8
Coulter Dry Goods Company vs. Wentworth, 171 Cal. 500	12
Curran vs. Arkansas, 15 How. 304.	7
Damiano vs. Bunting, 40 Cal. App. 566	12
Dennis vs. Superior Court, 91 Cal. 548.	12
Detroit United R. Company vs. Michigan, 242 U. S. 238.	10
Douglass vs. Pike County, 101 U. S. 677, 687.	6, 15
Edwards vs. Kearzey, 96 U. S. 595.	5, 7, 9, 15
Ennis Water Works vs. Ennis, 233 U. S. 652.	6, 15
Farrington vs. Tennessee, 95 U. S. 683.	8
Fletcher vs. Peck, 6 C. R. 87.	5
Foreign Mines Development Company vs. Boyes, 180 Fed. 594.	12
Georgia R. and Power Company vs. Decatur, 262 U. S. 432.	10
Great Southern Fireproof Hotel Company vs. Jones, 193 U. S. 532, 548.	6, 15
Green vs. Biddle, 8 Wheat. 1.	8
Gunn vs. Berry, 15 Wall. 610.	9
Hendrikson vs. Apperson, 245 U. S. 105.	8
Holt vs. Thomas, 105 Cal. 273.	14
Home Building and Loan Ass'n vs. Blaisdell, 290 U. S. 398.	8

TABLE OF CASES AND AUTHORITIES CITED

	<i>Page</i>
Houston and T. C. R. Company vs. Texas, 177 U. S. 77.	10
Hoyt vs. Hart, 13 Wall. 646.	9
In Re: California Mutual Life Insurance Company, 81 Cal. 364... 14	14
Kennedy vs. California Savings Bank, 97 Cal. 93.	12
Linger vs. Potsford, 32 Cal. App. 386.	12
Louisiana vs. New Orleans, 102 U. S. 203, 206.	7
Louisiana vs. Pillsbury, 105 U. S. 278, 295.	6, 15
Louisiana vs. St. Martin's Parish, 111 U. S. 716, 720.	7, 9
Major vs. Walker, 23 Cal. App. 465.	12
McCracken vs. Hayward, 2 How. 608, 612.	5, 7, 8
McGahey vs. Virginia, 135 U. S. 662, 693.	9
McGowan vs. McDonald, 111 Cal. 57.	12
Meza vs. Sword, 136 Cal. App. 292.	12
Muhlker vs. New York and H. R. Company, 197 U. S. 544, 570....	6, 15
Murray vs. Charleston, 96 U. S. 432, 444.	5
Oden vs. Saunders, 12 Wheat. 213.	5
Patek vs. California Cotton Mills, 4 Cal. App. 2nd 12, 40 Pac. 2nd 921.	3, 4, 25
Planters Bank vs. Sharp, 6 How. 301.	8, 9
Pritchard vs. Norton, 106 U. S. 124.	8
Rees vs. Watertown, 19 Wall. 107.	9
Royal Trust Company vs. McBean, 168 Cal. 642.	12
Sacramento Bank vs. Pacific Bank, 124 Cal. 147.	13, 14, 16, 17, 19, 20, 22
Sauer vs. New York, 206 U. S. 536.	6
Seton Hall College vs. South Orange, 242 U. S. 100.	10
Sturges vs. Crowninshield, 4 Wheat. 122.	5, 7
Trinidad vs. Atwater Canning Company, 128 Pac. 756.	14
U. S. Constitution, Article 1, Section 10, Clause 1.	5, 26, 29
United States vs. Quincy, 4 Wall. 535, 550.	5, 7, 8, 9
Walker vs. Whitehead, 16 Wall. 314.	5, 7, 8, 9, 15
Waring vs. Pitcher, 135 Cal. App. 493.	12
West River Bridge Company vs. Dix, 6 How. 507, 532.	5
Worthen Company vs. Kavanaugh, 295 U. S. 56.	7, 9

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THOMAS J. SMITHERAM, E. W. SQUIER, and J. F. GOUX,

Appellees,

APPELLANTS' PETITION FOR REHEARING

TO THE HONORABLE UNITED STATES CIR-
CUIT COURT OF APPEALS FOR THE NINTH
DISTRICT, AND THE HONORABLE JUDGES
THEREOF:

J. H. McCune, Alice W. Jackson, Alice P. Jackson, and Fred D. Jackson, Appellants herein, respectfully request a re-hearing in the within cause, for the reasons and upon the grounds hereinafter set forth. Proper certificate of counsel in compliance with Rule 25 of the within Court is appended hereto.

“A”

GROUNDS FOR RE-HEARING

Appellants hereby respectfully set forth the following grounds and reason upon which a re-hearing should be granted in the within cause:

1. Material points of law and fact are overlooked by the Court in arriving at its decision.

2. The decision of the Court is based upon premises and principles of law which are erroneous.

3. The within cause involves constitutional questions upon which the Appellants believe the decision of the Court to be in error.

4. The importance of the question of law involved is such, and the effect of the decision on pending matters and litigation is such, as to merit a re-examination and re-hearing of the cause.

5. Statements of the Court in the decision are not clear, and the decision is being, and is subject to being, cited as authority for principles of law which are erroneous. The Court by its language makes implied

findings of law which Appellants feel were not intended, and which are in error.

6. Statements of law and judicial decisions relied upon by the Court in reaching its decision are not applicable in the instant case.

“B”

**DOES SECTION 322a OF THE CIVIL CODE OF THE STATE
OF CALIFORNIA IMPAIR THE OBLIGATION OF
CONTRACTS IN VIOLATION OF ARTICLE 1,
SECTION 10, CLAUSE 1, OF THE
UNITED STATES CONSTITUTION?**

The within Court in its decision has stated as follows:

“We agree with *Patek vs. California Cotton Mills*, 4 Cal. App. 2nd 12, 40 Pac. 2nd 927, that Section 322a is not unconstitutional. So far as the creditor is concerned he has the same rights he had before the enactment of the statute, i.e., the right to proceed against the stockholders and the right to proceed against the corporation and share in the assets. The creditor has been deprived of none of his rights although his exercise thereof may bear less fruit, but he is in no different position, for instance, than if taxes were increased, for his recovery would then be less. A new right has been created where none existed before, but that right runs against the corporation not the creditor. The complaint in that respect should be made by the corporation not its creditors.” “With respect to the prohibition against impairment of obligations of a contract, the creditor had two obligations—that of the corporation to pay and that of the stockholder to pay. Neither has been impaired.”

Appellants respectfully submit that such statements by the Court in the opinion are in error in that:

1. As far as the creditor is concerned he has not the same rights he had before the enactment of the statute.
2. The creditor has been deprived of his rights and has been placed in a different position.
3. The new right which has been created runs not only against the corporation but against the creditor.
4. The contract of the creditor constituted more than the obligation of the corporation to pay and that of the stockholder to pay.
5. The obligation of such contract has been definitely and violently impaired.
6. The holding of the California Appellate Court in the Patek case cannot be applied in the instant case.

The argument and authorities which follow are respectfully submitted to the Court. Appellants feel that material points of law and fact have been overlooked by the Court in following the decision of the District Court of Appeal of the State of California in the case of *Patek vs. California Cotton Mills*, 4 Cal. App. 2nd 12.

**GENERAL RULES OF LAW
APPLICABLE TO THE CONSTITUTIONAL
QUESTION.**

No state may pass any law impairing the obligation of contracts.

AUTHORITY

United States Constitution, Article 1, Section 10, Clause 1.

This contract clause is a limitation on power of the states, whatever form it may assume, if a contract right is thereby impaired.

AUTHORITIES

Murray vs. Charleston, 96 U. S. 432, 444.

Sturges vs. Crownshield, 4 Wheat. 122.

Laws in force at the time a contract is entered into form a part of a contract, and any subsequent change of law which amounts to an impairment of the contract violates the provision of the Constitution.

AUTHORITIES

Fletcher vs. Peck, 6 CR. 87.

Oden vs. Saunders, 12 Wheat. 213.

Bronson vs. Kinzie, 1 How. 311, 315.

McCracken vs. Hayward, 2 How. 608, 612.

West River Bridge Company vs. Dix, 6 How. 507, 532.

United States vs. Quincy, 4 Wall. 535, 550.

Walker vs. Whitehead, 16 Wall. 314.

Edwards vs. Kearzey, 96 U. S. 595.

Abilene National Bank vs. Dolley, 228 U. S. 1.

Chicago, B. and Q. R. Company vs. Cram, 228 U. S. 70.

When a State Court has once interpreted a contract, that interpretation becomes part of the contract, and any subsequent change to the injury of a contracting party impairs the obligation of a contract.

AUTHORITIES

Sauer vs. New York, 206 U. S. 536.

Muhlker vs. New York and H. R. Company, 197 U. S. 544, 570.

After a statute has become settled by judicial construction, the construction becomes a part of the contract itself, and a change of decision operates as an impairment of the obligation of contract.

AUTHORITIES

Douglass vs. Pike County, 101 U. S. 677, 687.

Louisiana vs. Pilsbury, 105 U. S. 278, 295.

Settled judicial construction by State Courts is deemed to have been incorporated into the contract.

AUTHORITIES

Chicago vs. Sheldon, 9 Wall. 50.

Ennis Water Works vs. Ennis, 233 U. S. 652.

Great Southern Fireproof Hotel Company vs. Jones, 193 U. S. 532, 548.

While it has been held that legislation enhancing the cost and difficulty of performance, or diminishing the value of such performance, may impair the contract, but

does not necessarily impair the obligation of the contract so long as the obligation of performance remains in full force, it is nevertheless also true that the obligation of a contract includes everything within its obligatory scope; among these elements nothing is more important than the means of enforcement; this is the breath of its vital existence. Without it, the contract as such, ceases to be; the ideas of right and remedy are inseparable.

The obligation of a contract is in fact the law which binds the parties to perform their agreement. It is the means which at the time of its creation the law affords for its enforcement.

AUTHORITIES

Edwards vs. Kearzey, 96 U. S. 595, 600.

Sturges vs. Crowninshield, 4 Wheat. 122, 197.

Curran vs. Arkansas, 15 How. 304.

McCracken vs. Hayward, 2 How. 608.

United States vs. Quincy, 4 Wall. 535.

Worthen Company vs. Kavanaugh, 295 U. S. 56.

Louisiana vs. St. Martin's Parish, 111 U. S. 716, 720.

Louisiana vs. New Orleans, 102 U. S. 203, 206.

Walker vs. Whitehead, 16 Wall. 314.

Any law which, in its operation, amounts to a denial or obstruction of the rights accruing under a contract impairs its obligation, as does a law which diminishes

the duty to fulfill or impairs the right to enforce the contract. In other words, any law which invalidates, extinguishes, releases, or derogates from substantial contractual rights impairs its obligation.

AUTHORITIES

Cleveland vs. Pennsylvania, 15 Wall. 300, 320.

Colombia R. Gas and E. Company vs. South Carolina, 261 U. S. 236.

Bradley vs. Lightcap, 195 U. S. 1.

McCracken vs. Hayward, 2 How. 608.

Pritchard vs. Norton, 106 U. S. 124.

Home Building and Loan Ass'n vs. Blaisdell, 290 U. S. 398.

Hendrikson vs. Apperson, 245 U. S. 105.

The constitutional prohibition against impairment of contract obligations has no reference to degree of impairment. The extent of impairment is immaterial. It is not a question of degree. The obligation must not be diminished at all.

AUTHORITIES

United States vs. Quincy, 4 Wall. 535.

Green vs. Biddle, 8 Wheat. 1.

Walker vs. Whitehead, 16 Wall. 314.

Farrington vs. Tennessee, 95 U. S. 683.

Planters Bank vs. Sharp, 6 How. 301.

The means for the enforcement of a contract which exists at the time of its creation form a part of its obligation which a State cannot substantially destroy without violating the contract clause of the Constitution. The law which exists at the time of the making of a contract enters into and forms a part of it. This embraces those laws which affect its validity, construction, discharge, and enforcement. The remedies for the collection of a debt are essential parts of the contract of indebtedness, and those in existence at the time it is incurred must be substantially preserved to creditors.

AUTHORITIES

- Gunn vs. Berry*, 15 Wall. 610.
United States vs. Quincy, 4 Wall. 535.
Louisiana vs. St. Martin's Parish, 111 U. S. 716.
Hoyt vs. Hart, 13 Wall. 646.
Barnitz vs. Beverly, 163 U. S. 122.
McGahey vs. Virginia, 135 U. S. 662, 693.
Edwards vs. Kearzey, 96 U. S. 607.
Walker vs. Whitehead, 16 Wall. 314.
Butz vs. Muscatine, 8 Wall. 583.
Planter's Bank vs. Sharp, 6 How. 330.
W. B. Worthen Company vs. Kavanaugh, 295 U. S. 56.
Rees vs. Watertown, 19 Wall. 107.

It is the duty of a Federal Court to determine the extent, construction, and validity of the contract, and to

determine whether as so construed it has been impaired by any subsequent legislation to which effect has been given. When called upon to decide whether state legislation impairs the obligation of a contract, independent judgment should be exercised by a Federal Court upon these questions:

1. Was there a contract?
2. If so, what obligation arose from it?
3. Has that obligation been impaired by subsequent legislation?

AUTHORITIES

Houston and T. C. R. Company vs. Texas, 177 U. S. 77.

Seton Hall College vs. South Orange, 242 U. S. 100.

Detroit United R. Company vs. Michigan, 242 U. S. 238.

Georgia R. and Power Company vs. Decatur, 262 U. S. 432.

THE CONTRACT AND ITS OBLIGATION.

What, in the instant case, constituted the contract and its obligation?

This portion of this petition, being directed to the question of impairment and contract rights, is devoted of course to the contract claims of J. H. McCune and Alice W. Jackson. The original contract asserted by J. H.

McCune is a note obligation of the bankrupt to the County National Bank and Trust Company of Santa Barbara, which note obligation has been assigned to J. H. McCune. This note obligation was incurred by the Company prior to the repeal of stockholders' liability in California, and prior to the enactment of Section 322a of the Civil Code. The contract claim of Alice W. Jackson is in the same category as the contract claim of J. H. McCune.

In order to measure the original contract and its obligations to determine whether there has been any impairment, it is first necessary to determine, in accordance with the principles of law hereinabove set forth, what elements outside of the original writing in the contract became a vested part thereof, to be considered as a part thereof in determining whether or not contract rights have been impaired.

At the time of the making of the original contract, the creditor had a cause of action against the bankrupt, and a cause of action against the stockholders of the bankrupt. Both causes of action arose at the same time and were separate, distinct, and severable. The liability of the stockholder arose entirely by statute, but was, and has been held to be contractual in nature. The element of contract between creditor and the stockholder arose by reason of the fact that the stockholder by consenting to become such assumed the obligation imposed by the statute, and in effect contracted with any future creditors of the Company to be liable under the statute.

AUTHORITIES

- Royal Trust Company vs. McBean*, 168 Cal. 642.
Dennis vs. Superior Court, 91 Cal. 548.
Damiano vs. Bunting, 40 Cal. App. 566.
Lininger vs. Potsford, 32 Cal. App. 386.
Major vs. Walker, 23 Cal. App. 465
Foreign Mines Development Company vs. Boyes,
 180 Fed. 594.
Coulter Dry Goods Company vs. Wentworth, 171
 Cal. 500.
McGowan vs. McDonald, 111 Cal. 57.
Kennedy vs. California Savings Bank, 97 Cal. 93.
Waring vs. Pitcher, 135 Cal. App. 493.
*Adams Pipe Works vs. Okell Well Machinery
 Co.*, 136 Cal. App. 608.
Meza vs. Sword, 136 Cal. App. 292.
Aronson and Co. vs. Pearson, 199 Cal. 286.

At the time of the original contract, the stockholder had no right or cause of action against the bankrupt in the event the stockholder paid a portion of the Corporation indebtedness under the statutory stockholders' liability. This appears to be so by reason of the fact that the liability of the stockholder was a separate and several liability, and the stockholder had no right to recover from the corporation by subrogation or otherwise. In addition thereto, it has been held that a stockholder could not, under the provisions of Section 309 of the Civil Code of the State of California in effect at such time, now incor-

porated into Sections 346, 363, and 364 of the same Code, share in the assets or the dividends of an insolvent corporation, by subrogation or otherwise. This proposition seems to have been settled both by statute and by judicial decision at the time the contracts now before this Court were entered into. (*Sacramento Bank vs. Pacific Bank*, 124 Cal. 147).

Section 322a of the Civil Code did create a new right, therefore, where none existed before. Before its enactment, the stockholder of a corporation by becoming such stockholder contracted as to creditors not to share in the assets of the corporation, especially an insolvent corporation, by subrogation or otherwise, and not to have or exercise a right or cause of action against the corporation after payment of a portion of a creditor's claim by reason of such stockholder's liability.

The proposition that a stockholder, prior to enactment of Section 322a, Civil Code, contracted not to share in the assets of a corporation by subrogation or otherwise appears settled by reason of the fact that at the time the corporate contract was entered into such stockholder had no such right or cause of action against the corporation. This being in effect the state of law which existed at the time the corporate contract was entered into, such state of law entered into the terms of the contract insofar as its interpretation is concerned relative to the impairment of contracts. This proposition was settled by statute, and by judicial decision. So too, the stockholder of a cor-

poration by becoming such contracted as to creditors not to proceed or have a right or cause of action against the corporation after payment of a portion of the creditor's claim. This is so because the state of law which existed at the time the contract came into existence was such as to preclude such right or cause of action in favor of the stockholder. There was, therefore, a waiver by contract of any right of subrogation insofar as a creditor is concerned, especially in the case of an insolvent corporation.

AUTHORITIES

Sacramento Bank vs. Pacific Bank, 124 Cal. 147.

Trinidad vs. Atwater Canning Company, 128 Pac. 756.

Holt vs. Thomas, 105 Cal. 273.

In Re: *California Mutual Life Insurance Company*, 81 Cal. 364.

See also all authorities hereinabove cited.

It necessarily appears, therefore, that the measure of the contract with respect to the impairment clause of the Constitution of the United States is the writing of the contract itself together with the above mentioned matters of statute and decision incorporated therein by the law and settled judicial decision in force at the time of the original contract.

AUTHORITIES

Edwards vs. Kearzey, 96 U. S. 595.

Walker vs. Whitehead, 16 Wall. 314.

Muhlker vs. New York and H. P. R. Company,
197 U. S. 544.

Douglas vs. Pike County, 101 U. S. 677, 687.

Louisiana vs. Pilsbury, 105 U. S. 278, 295.

Chicago vs. Sheldon, 9 Wall. 50.

Ennis Water Works vs. Ennis, 233 U. S. 652.

Great Southern Fireproof Hotel Company vs. Jones, 193, U. S. 532, 548.

In the instant case, therefore, the contract creditor acquired by contract, as such contract is to be measured in interpreting the same and in defining the obligations thereof with respect to the impairment thereof under the United States Constitution, the following:

1. The obligation of the corporation under the written contract to pay the amount of the obligation.

2. The obligation of the stockholder for payment of a proportionate share of the corporate obligation to the debtor. This obligation was settled by statute, and unquestionably formed an integral part of the contract.

AUTHORITIES

Aronson and Co. vs. Pearson, 199 Cal. 286.

Other cases hereinabove cited.

3. The obligation of the creditor not to have recourse against the corporation or its assets, by subrogation or

otherwise. This appears to be a necessary conclusion, because the settled statutory law and judicial decision in the State of California at the time the contracts were made and entered into established that the stockholder had no recourse against the corporation after payment of its stockholder's liability, and therefore the stockholder had no recourse against its assets on such claim. In the case of an insolvent corporation, the statutory law specifically precluded the stockholder from sharing in any assets of the corporation ahead of the creditor.

AUTHORITIES

Sacramento Bank vs. Pacific Bank, 124 Cal. 147.

Other cases hereinabove cited.

4. The right to proceed against the corporation and its assets, and in particular to proceed against its assets free and clear of any claim of a stockholder, arising by subrogation or otherwise, particularly if the corporation be insolvent.

AUTHORITIES

Sacramento Bank vs. Pacific Bank, 124 Cal. 147.

Other cases hereinabove cited.

5. The right to proceed against the stockholder and his assets for the proportionate stockholder's liability as established by statute.

AUTHORITIES

Aronson and Co. vs. Pearson, 199 Cal. 286.

Other cases hereinabove cited.

6. The right, in case of an insolvent corporation to share in its assets free of the claim of a stockholder by subrogation or otherwise.

AUTHORITIES

Sacramento Bank vs. Pacific Bank, 124 Cal. 147.

Other cases hereinabove cited.

**IMPAIRMENT OF THE
CONTRACT OBLIGATIONS.**

Appellants respectfully submit that each and every right and obligation accruing under the corporate contracts, as just hereinabove listed, has been definitely impaired by the enactment and application of Section 322a of the Civil Code. Taking up for discussion the manner in which such impairment has been effective in relation to each such right and obligation, appellants submit the following argument. Each subdivision of the argument corresponds with the same numbered subdivision designating the rights and liabilities accruing under the contracts as just hereinabove set forth.

1. The obligation of the corporation to pay the amount to be paid to the creditor under the contract has been impaired. True, the original cause of action against the corporation yet exists, but the obligation of the cor-

poration to pay the contract amount extends not only to its literal written promise to pay, but includes the obligation to make its assets available for such payment in the event of insolvency, and includes the right of a creditor to have recourse to such assets for payment of a creditor's claim. Such right and obligation of the contract, under the settled statutory law and settled judicial decision in effect at the time of the making of the contract, includes the right of the creditor to proceed against the corporate assets, and in particular the assets of an insolvent corporation, free of any claim of a stockholder of such corporation, whether such stockholder's claim arose by subrogation or otherwise. Has this right been impaired? Definitely it has, because under the present decision of the within Court, the stockholders, under their subrogated claims, have equal rights to corporate assets with the creditor, and the creditor's right of recovery has been lessened and impaired to that extent. As a concrete example, let us assume the existence of a corporation with corporate liabilities of \$100,000.00. Total creditor claims are \$200,000.00, represented by a first creditor claim of \$100,000.00 and a second creditor claim of \$100,000.00. Assume further, the existence of a stockholder holding 50% of the corporate stock. Under these conditions, and prior to the enactment of Section 322a, creditor number one proceeds against the stockholder and recovers one-half of his creditor's claim, or the sum of \$50,000.00. Creditor number one thereupon presents his total claim in the insolvency proceedings, and receives a dividend

of 50% thereon, or a further sum of \$50,000.00, making in all a total recovery of \$100,000.00. That the creditor could present his entire claim in the insolvency proceedings after collecting a portion thereof from the stockholder appears to be established as a principal of law in the case of *Sacramento Bank vs. Pacific Bank*, 124 Cal. 147. Under these conditions, therefore, the creditor would have recovered the entire amount of his claim. Even assuming, however, for the purpose of this example, that after collecting the \$50,000.00 from the stockholder, the creditor could only prove the balance of his claim, \$50,000.00, in the insolvency proceedings, he would receive in the insolvency proceedings a dividend of \$33,333.33, making a total recovery of \$83,333.33. In this event, creditor number two would recover from the insolvent estate a dividend of \$66,666.66, and yet have recourse against the stockholder.

Measure against this example, the rights of a creditor after the enactment of Section 322a, if it be construed in the manner designated in the prior opinion of this Court. In that event, creditor number one would proceed against the stockholder and recover 50% of his claim, or a total sum of \$50,000.00. The stockholder would thereupon become subrogated to the amount of such payment, and would thereupon have a claim of \$50,000.00 against the corporation. Creditor number two and creditor number one and the subrogated stockholder then being able to prove claims against the insolvent estate, the recovery of the creditor number one from the insolvent estate would

be limited to a sum of \$25,000.00, making a total recovery of \$75,000.00 as against a minimum recovery of \$83,333.33 prior to Section 322a as hereinabove set forth, and as against a total and full recovery of \$100,000.00 under the authority of the rule set forth in *Sacramento Bank vs. Pacific Bank*, 124 Cal. 147.

It is mathematically certain, therefore, that Section 322a takes away from the creditor a substantial right of recovery, and the obligation of the contract has thereby been impaired. It is true that this Court in its opinion has said "The creditor has been deprived of none of his rights although his exercise thereof may bear less fruit, but he is in no different position, for instance, than if taxes were increased, for his recovery would then be less." The appellants must respectfully contend that such a statement is not a correct statement of the law. Depriving a creditor of an asset of the insolvent corporation is clearly an impairment of a right and obligation accrued under the contract. To say that the creditor is in no different position than if taxes were increased is also in error, and brings into the argument the question of a further rule of law which is fundamental. It is fundamental that the power of a State to tax, and to exercise its police power, is a sovereign power, the exercise of which is essential to the existence of the State. The exercise of such right, therefore, does not or cannot come within the prohibition of the impairment of contract clause of the United States Constitution. If a contract right is impaired by an increase of tax, or a recovery under a contract is made less

by such increase in tax, or by the exercise by the State of its sovereign police power, there is possibly no violation of the constitutional prohibition against the impairment of the obligation of contract. But such sovereign right, such power of taxation, such police power, are not here involved. Section 322a is not an exercise of a sovereign right or power, and does do violence to the rights and obligations which accrued under the contract here presented.

2. The obligation of the stockholder for payment of a proportionate share of the debt has also been impaired. Under the statutory law and the judicial decisions in effect at the time the contracts were made, the obligation of the stockholders for such payment existed without recourse on the part of the stockholder to the assets of the corporation, and in particular to the assets of an insolvent corporation. If Section 322a is to be held constitutional and given the interpretation as set forth in the decision of this Court, this obligation has definitely been impaired, in that the stockholder has been given a right which did not exist before, to pay a portion of his stockholder's liability from the assets of the insolvent corporation. Measured again by the concrete example hereinabove set forth, the stockholder, if he was required to pay the \$50,000.00 as payment of one-half of the creditor's claim, could thereupon recover from the insolvent corporation's estate the sum of \$25,000.00 by reason of subrogation under Section 322a, all to the impairment of the vested rights of the creditor.

3. The obligation of the creditor not to have recourse against the corporation or its assets, by subrogation or otherwise, has also been impaired. Prior to the enactment of Section 322a, under settled statutory law and judicial decisions, the creditor could not have recourse against the corporation or its assets, by subrogation or otherwise. (*Sacramento Bank vs. Pacific Bank*, 124 Cal. 147). This obligation became an integral part of the contract. Section 322a violates and impairs this obligation in that it directly gives the creditor recourse against the corporation and against its assets, even though insolvent, to the damage and detriment of the creditor.

4. The right to proceed against the corporation and its assets has been impaired, in that the right of the creditor to proceed against all the assets of a corporation, and in particular an insolvent corporation, has been taken away by the subrogation under Section 322a of the stockholder to a portion of the creditor claim. In effect, again under the concrete example hereinabove set forth, one-fourth of the assets of the insolvent corporation have been removed from the reach of the creditors of the corporation. This has been accomplished by special statute, and not in the exercise of the power of taxation or of the police power of the State.

5. The right to proceed against the stockholder and his assets has also been impaired. Prior to the enactment of Section 322a of the Civil Code, the creditor had separate, several, and distinct causes of action against the

corporation and the stockholder. After the enactment of Section 322a, the creditor has no longer the unrestricted right to proceed against the stockholder and the assets of the stockholder, but is placed in the position of proceeding against the stockholder at the risk of lessening his recovery against the corporation and at the risk of subjecting to the claim of a stockholder a portion of the corporate assets.

6. The contract right of the creditor, in case of an insolvent corporation, to share in its assets free of the claim of a stockholder by subrogation or otherwise has been impaired. The argument and examples hereinabove set forth clearly establish this point.

**SPECIFIC ERRORS IN THE
STATEMENTS OF THE COURT
IN ITS DECISION.**

This Court in its decision has said: "So far as the creditor is concerned he has the same rights he had before the enactment of the statute, i. e., the right to proceed against the stockholders and the right to proceed against the corporation and share in the assets." In accordance with the argument, authorities, and examples hereinabove set forth, appellants respectfully submit that the creditor has not the same rights he had before the enactment of the statute. The obligation of the corporation to pay the creditor has been impaired. The obligation of a corporation to make its assets available for payment of creditor claims, especially in the event of in-

solvency, has been impaired. The right of the creditor to resort to such assets to the exclusion of stockholders has been taken away. The right to proceed against the stockholder and the assets of the stockholder has been impaired. In these respects the creditor has been deprived of his vested rights. The fact that the exercise of his remaining rights after the enactment of Section 322a must bear less fruit is conclusive upon the proposition that material contract rights have been taken away from the creditor, and taken away by special legislation and not by legislation enacted in the exercise of the power of taxation or of the police power of a State.

This Court in its decision has said: "A new right has been created where none existed before, but that right runs against the corporation not the creditor." Appellants are obliged to contend that this statement is in error. It is true that new rights have been created, but such new rights run directly against the creditor and do not materially effect the corporation in any manner, especially if the corporation be insolvent. A new right has been given to a stockholder to be subrogated to a portion of the creditor's claim against the corporation and to be allowed a direct cause of action against the corporation for such subrogated portion. This new right runs directly against the creditor, in that it takes directly from the creditor material and substantial rights of property which had accrued to the creditor under the original contract. The new right runs against the creditor because it gives the stockholder a right to assets which were theretofore

available solely to the creditor in payment of his claim, and to the exclusion of the stockholder. A new right has been created in favor of the stockholder and against the creditor in that the stockholder has been given a right to share with the creditor in the assets of an insolvent corporation. A new right has been given to the stockholder as against the creditor in that the stockholder has been given the right to recover from corporate assets theretofore specifically subject only to the creditor's claim a portion of any amount paid by the stockholder to the creditor under stockholder's liability.

This Court in its opinion has said: "With respect to the prohibition against impairment of obligations of a contract, the creditor had two obligations—that of the corporation to pay and that of the stockholder to pay. Neither has been impaired." The argument, authorities, and examples hereinabove set forth establish that the obligations of the contract have been impaired, when the obligations of the contract are measured not alone by the written words of the contract, but by the measure which should be applied when determining whether or not the obligation of such a contract has been impaired by state legislation.

This Court in its opinion has said: "We agree with *Patek vs. California Cotton Mills*, 4 Cal. App. 2nd 12, 40 Pac. 2nd. 927, that Section 322a is not unconstitutional." But the holdings of the District Court of Appeals of the First District, State of California, in the *Patek*

case, are not applicable or controlling here in any manner. In the Patek case, the Court had to do with a corporation which was admittedly solvent. The entire opinion and the conclusions of the Court in the Patek case are primarily based upon the theory that there was no question of insolvency. The rights of creditors were not involved. The action was merely an action brought by a stockholder who had paid a portion of a creditor's claim against a solvent corporation. The various rights of a creditor, and the obligations which arise from the contract of a creditor, were not before the Court in the Patek case, and were therefore not adjudicated or determined therein. It is apparent from a reading of the Patek case, and a digest of the entire opinion, that the Court in the Patek case had in mind that creditor's rights in connection with Section 322a would present a different problem than the problems which were there presented to the Court. The Court stated:

“Every subscriber for stock agreed that liability imposed by Section 3, Article 12, of the Constitution, and Section 322 of the Civil Code, was a term and was of the obligation of his contract with the corporation. If as between him and it those provisions obligated the stockholder to pay the corporation's debt, the corporation had a vested right to have him pay such debt, and the repeal of those provisions violated the obligations of the subscription contract as to all debts incurred by the corporation after the stockholder received his certificate of stock. *The repeal had no such effect because the provisions referred to were enacted for the benefit of the creditor and not for the benefit of the corporation.*” (Italics ours).

Is this not a direct finding that the obligation of a stockholder to pay a creditor, as it existed prior to the enactment of Section 322a of the Civil Code, was a direct part of the contract and obligation which arose when the creditor's claim came into existence? The Court further states:

“The means for the protection of their rights is available, namely, by intervention or other appropriate procedural methods whereby issue could be joined as to the solvency of the corporation.”

Is this not then a direct holding that in the instance of an insolvent corporation creditor's rights are to be protected against the literal provisions of Section 322a of the Civil Code? Appellants respectfully submit again to the Court that the Patek case is not authority for the holding and finding of this Court in its opinion.

This Court in its opinion has also stated as follows:

“Under this statute, the stockholder succeeds to the rights of the creditor against the corporation to the extent of the amount paid by the stockholder. The stockholder to the extent of such amount is substituted for the creditor. The corporate obligation becomes divided, and is several, the creditor no longer having an interest in the part of the obligation to which the stockholder succeeds. The situation is the same as if the corporation had made separate notes to the creditor and to the stockholder.”

The appellants respectfully submit that the statements of the Court in this paragraph are far too broad and do not correctly state the law. The Court states that the creditor no longer has any interest in the part of the obligation to

which the stockholder succeeds. That this is not the true state of fact appears from the proposition that the creditor is interested and has an interest in the part of the obligation to which the stockholder succeeds, in that the creditor is interested in his right not to have that part of the obligation paid or satisfied from the assets of an insolvent debtor until the entire claim of the creditor has been paid. This is a vested interest and right which accrued to the creditor at the time the obligation was incurred. The Court states that the corporate obligation becomes divided and is several, and that the situation is the same as if the corporation had made separate notes to the creditors and to the stockholders. The wording of the Court is unfortunate in that it gives rise to implications which we do not believe were intended. The Court in effect holds, by stating that the situation is the same as if the corporation had made separate notes, that the original obligation has been divided, separated, and now constitutes two separate and distinct obligations. This in effect holds that the stockholder has a new, separate, and distinct right and cause of action against the corporation, which is obviously not intended by the statute itself. Section 322a provides that the stockholder be subrogated to the extent of his payment to the claim of the creditor against the corporation. Definitely the wording of the statute creates a subrogation. Definitely also, the wording of the statute does not create a new, separate and distinct cause of action. If the legislature so intended, the statute would have provided that upon payment of the stockhold-

er's liability by a stockholder, the stockholder should thereupon have a new, separate, and distinct cause of action against the corporation for the amount so paid. Not having so provided, appellants contend that such construction cannot be read into the statute in face of the direct wording thereof which provides for a subrogation only. The wording of this Court in the paragraph just hereinabove mentioned has been used and presented as authority for the proposition that the subrogated stockholder's claim is a new, separate, and direct obligation against the corporation, and not a subrogation as intended and provided by the statute. The opinion in the instant case has been cited as authority for this contention in two cases now pending in the Superior Court of the State of California, in and for the County of Santa Barbara. Appellants respectfully contend that the opinion of this Court is in error in this respect, and that the opinion should be corrected so that results will not accrue therefrom which were not intended by the Court.

In concluding this portion of the argument, appellants respectfully contend that Section 322a of the Civil Code of the State of California, if given the construction set forth in the opinion of this Court, violates the provisions of Article I, Section 10, Clause 1, of the Constitution of the United States, and of Amendment 14 of the Constitution of the United States.

“C”

**DOES SECTION 322a OF THE CIVIL CODE OF THE STATE
OF CALIFORNIA VIOLATE THE PROVISIONS OF
ARTICLE I, PARAGRAPHS 13 AND 16, OF
THE CONSTITUTION OF THE STATE
OF CALIFORNIA?**

The argument, reasoning, authorities, and examples hereinabove set forth, are equally applicable to the question of whether or not Section 322a is unconstitutional under the provisions of the Constitution of the State of California hereinabove cited. Appellants respectfully submit that Section 322a of the Civil Code impairs the obligation of contract and deprives the creditor of property without due process of law in violation of the specific named sections of the Constitution of the State of California.

“D”

**CAN SECTION 322a OF THE CIVIL CODE OF THE STATE
OF CALIFORNIA BE CONSTRUED IN SUCH A MANNER
AS NOT TO MAKE IT VIOLATIVE OF THE
CONSTITUTIONS?**

Section 322a of the Civil Code of the State of California can be held to be constitutional only if it is to be construed in such a manner as not to impair vested rights of contract.

Appellants respectfully contend that the only manner in which Section 322a of the Civil Code of the State of California can be held to be constitutional is to construe this Section in such a manner as that the said Section, or the enforcement thereof, will not interfere with rights

which have vested, and will not constitute an impairment of the obligation of a contract. In order to do this, the subrogated stockholder may be accorded only the rights and remedies usually accorded to any other person who is partially subrogated to a creditor's claim.

Appellants do not claim that the stockholders were sureties for the corporation. Appellants do claim, however, that the obligation of a stockholder as it existed at the time the contracts were entered into was in the nature of a continuing guarantee of the payment of the corporate debts. (*Aronson and Co. vs. Pearson*, 199 Cal. 286.) Appellants further respectfully contend that if Section 322a is to be construed in such a manner as to render it constitutional, then the subrogated stockholder must occupy a position which is directly analogous to the position of a surety or an endorser who has paid a portion of a creditor's claim and is entitled to partial subrogation. In this event, the subrogated stockholder would not and could not have a claim which would be on an equal basis or parity with the claim of the original creditor in the bankruptcy proceedings. It would follow as of necessity that the full amount of the creditor's claim must first be satisfied before the stockholder be entitled to share in the assets of an insolvent corporation. It follows further, if these premises be correct, that the subrogated stockholder would not, unless the stockholder had paid the entire claim of a creditor, have a provable claim in bankruptcy. A considerable portion of "Appellants' Opening Brief" is devoted to the discussion of the analagous status of a

surety or endorser who has paid a portion of a creditor claim, and the Court is referred thereto for such complete discussion. Let be remembered that although the subrogated stockholder may not in strict construction be termed a surety of the corporation, nevertheless he is a continuing guarantor of the corporation indebtedness, and if he becomes subrogated to a portion of a creditor's claim, stands thereupon in a position which is exactly analogous to the position of a surety or an endorser who has paid a portion of a creditor's claim. In such event, no provable claim in bankruptcy vests in such subrogated stockholder.

CONCLUSION

By reason of all the facts, argument, authorities, and examples hereinabove set forth, appellants respectfully request that a rehearing be granted in the within matter. Too great importance cannot be placed upon the fact that the opinion of this Court is in its present condition subject to erroneous interpretation and construction. The law with respect to the points involved in this appeal will, when settled by a final decision herein, probably become the law of the case in the bankruptcy proceedings, and many and other various rights and equities of creditors and stockholders will be directly effected thereby.

Respectfully submitted,

T. H. CANFIELD,

Attorney for Appellants.

C E R T I F I C A T E

STATE OF CALIFORNIA, }
 COUNTY OF SANTA BARBARA } ss.

T. H. CANFIELD, being duly sworn, deposes and says:

That he is attorney for the appellants in the within cause; that he has devoted study and research to the questions of law presented in the within appeal, and further study and research to the decision of the within Court affirming the orders of the District Court of the United States, Southern District of California, Central Division;

That he hereby certifies that in his judgment the within "Appellants' Petition for Re-Hearing" is well founded; and that the same is not interposed for the purpose of delay.

Dated this 27th day of February, 1940.

Subscribed and sworn to before me,
 this 27th day of February, 1940.

J. V. Wood

Notary Public in and for said
 County and State.

(Seal)

J. W. Canfield

